

**CITY OF LODI
INFORMAL INFORMATIONAL MEETING
"SHIRTSLEEVE" SESSION
CARNEGIE FORUM, 305 WEST PINE STREET
TUESDAY, JUNE 6, 2006**

An Informal Informational Meeting ("Shirtsleeve" Session) of the Lodi City Council was held Tuesday, June 6, 2006, commencing at 7:01 a.m.

A. ROLL CALL

Present: Council Members – Beckman, Hansen, Johnson, Mounce, and Mayor Hitchcock
Absent: Council Members – None
Also Present: City Manager King, Deputy City Attorney Magdich, and Interim City Clerk Perrin

B. TOPIC(S)

B-1 "Continued presentation of the fiscal year 2006-07 recommended draft budget"

With the aid of a PowerPoint presentation (filed), Electric Utility Director Morrow reported that the fiscal year 2006-07 budget is balanced, the sales forecast is updated, which indicates that power costs will be lower, and the costs associated with normal capital have been included in the rates in order to avoid utilizing bond proceeds.

Council Member Beckman questioned how the capital costs are allocated through the rates (i.e. on a per kilowatt or a per customer basis), to which Mr. Morrow responded that they are paid from regular retail revenues equally from all rate classes. Electric Utility staff will be reporting to Council at a future Shirtsleeve Session regarding capital costs for line extensions, new development, and for cost recovery.

Mr. Morrow reviewed the breakdown of costs for administration, planning, operations, and construction and pointed out that capital costs were rolled into those figures, which explains the zero balance in capital for 2006-07 as compared to \$1.5 million in the current budget year. The total net effect between the two budget years is an increase of \$73,754.

In response to Council Member Hansen, Mr. Morrow explained that the increase in debt service was a result of the variable cost element in the swap agreement and the rising interest rates. Mr. Hansen stated that the City was at a fixed rate until the previous administration changed it to a variable rate, for which the City is now paying the price.

Deputy City Manager Krueger explained that there were several swaps for different purposes, which included changing from a fixed to variable rate as well as hedges that were intended to protect the City should variable rates increase too high. He noted that, on one of the swaps, the City received \$4.3 million in fiscal year 2003-04.

In response to Council Member Hansen, Mr. Krueger stated that he would provide Council with information on what the City was paying on the fixed rate, what it is paying now on the variable rate, and what the ceiling is.

Mr. King reported that the City's debt service payments for fiscal year 2006-07 for Electric Utility will be in excess of \$6 million and it is calculated that fiscal years 2007-08 and 2008-09 will increase to \$7 million.

Council Member Hansen commented that a rational approach would be to lock in at a fixed interest rate so as not to be subject to the volatility of the economy. The \$4.3 million received as a result of the change to the lower variable rate was a short-term cash infusion, but the risk was paying a higher price down the road.

Mr. Morrow reported that the capital budget includes the major capital projects that will be paid from bond proceeds. Those projects include the scaled-back Killelea Substation and completion of the extension of the west side 60kV line, which will connect to a new substation to the west. Net revenue for this current year is \$6 million and is projected to be \$13 million in 2006-07, which will cover the debt service and in-lieu of transfer. The 2006-07 budget moves the Utility from a negative \$7 million to a balanced budget. Retail revenues projected for the next fiscal year are \$65 million, which is a \$7 million, or 12%, increase. This figure includes a full year of the rate increases; whereas, in fiscal year 2005-06, those revenues were realized for a partial year. On the power supply side, the projected net income for fiscal year 2005-06 is on target.

Lodi's budget amount for the Northern California Power Agency (NCPA) for next year is \$41.9 million, which represents a 5% decrease. NCPA has four categories of costs: 1) generation, which includes the power plants it operates and maintains for the members; 2) transmission, which includes costs associated with the Transmission Agency of Northern California and the California Independent System Operator (CAISO); 3) management services, which includes legislative and regulatory, power supply management, planning, and its system operations; and 4) third-party revenue, which accounts for reductions in cost for sales that NCPA makes. NCPA's total budget for fiscal year 2006-07 is \$296 million, which is a decrease of 1.2%. After deducting \$30 million from sales in the third-party revenue category, the net bill to NCPA members is \$266 million, for which Lodi would pay its proportional share. NCPA is anticipating a significant drop next year as some of its debt service matures. In 2011, the geothermal, transmission, and combustion turbine bonds all pay off.

Mayor Pro Tempore Johnson questioned whether NCPA had a history of refinancing existing projects to fund future capital projects, to which Mr. Morrow responded that it does not; however, he believed that NCPA would take advantage of refinancing if there were favorable market conditions.

There are 167 full-time employees at NCPA, with the bulk of the employees in the power management side. The NCPA member cost forecast indicates a trend that costs have increased from last year and, for most members, it reflects an impact of the market and open position.

In response to Mayor Hitchcock, Mr. Morrow stated that Roseville is moving outside of the NCPA pool and will manage its own resources by either contracting the service out or hiring additional staff. The primary reason behind Roseville's decision is the issue on the control area. It has moved out of the CAISO controlled area and into the Western/Sacramento Municipal Utility District (SMUD) control area.

City Manager King added that the significance of Roseville stepping out of NCPA is that the fixed costs will be spread out over the remaining base and that costs will increase. NCPA's response has been to bring Bay Area Rapid Transit (BART) in as a member to replace Roseville. The city of Roseville will remain a part of NCPA on joint action and lobbying issues but not for power purchases.

Mayor Pro Tempore Johnson stated that the Roseville situation highlights the need for the City's interconnection to Western and he questioned, with the City's financial position, how that project could be moved to the forefront.

Mr. Morrow replied that the goal is to bring the transmission line project forward in conjunction with the Lodi project at White Slough, which is anticipated for 2009-10. It appears that the Lodi project now has a higher probability due to the fact that the Resource 500 project is deferred. There may be some ancillary benefits to other NCPA participants in that project, which could provide some financial support.

Council Member Hansen reported that significant improvement has been made at NCPA to create a policy to deal with member agencies leaving the joint powers authority. The plan is that members would provide a seven-year notice in order to allow time to make the necessary adjustments and to lessen the impact among the remaining members.

Mr. Morrow reported that NCPA has a concept of what each member should have in reserves, which can be stored at NCPA in its general operating reserve (GOR) or with the member agency directly. Because of the City's current financial condition, the GOR will be lower than what NCPA prefers. There are only two sources for the GOR: one is the difference between NCPA's estimated bill and the actual costs and the second is special payments received by NCPA for settlements of rate cases or lawsuits.

Mr. Krueger reported that the balance of the GOR in 1996-97 was \$18 million; earlier this fiscal year, it was \$700,000; and the current balance is \$2.5 million. In 1996, the GOR amount was not shown in the City's records; however, it is presently reflected in the City's Comprehensive Annual Financial Report (CAFR) with the amount updated each month upon receipt of a statement from NCPA.

Mr. Morrow added that the City will utilize a portion of the GOR this year to balance the budget; however, there is no plan to spend the GOR next year so that it may rebuild. The \$5 million reserve level is not reflective of what the Utility should have in total reserves because an additional amount should be included for working capital.

In response to Mayor Pro Tempore Johnson, Mr. Morrow explained that the GOR typically grows an average of \$70,000 to \$80,000 per month, or \$1 million annually.

Mr. Morrow reported that the charter for the CAISO is to monitor and operate the transmission system and its costs for doing so have grown dramatically from \$500,000 a month in 2003-04 to \$2.5 million a month starting in 2005. CAISO has instituted a new transmission service charge methodology for transmission from third parties. There is a new trend in the Federal Energy Regulatory Commission to allow higher rates of return for transmission, over which the City has very little control. The potential to see future increases does still exist, which is another reason to have a healthy reserve level.

In October 2005, the City purchased 115,070 megawatt hours at \$100 per megawatt hour for a total amount of \$11 million. Had the City purchased the power in April or May 2005, it would have saved \$4 million. The high point of the market came in December 2005, and had the City waited, it would have cost an additional \$1 million. Mr. Morrow demonstrated how vastly the market can fluctuate.

Council Member Hansen stated that the Council and City Manager were led to believe that the power had been purchased at the lower prices in April when they were not, which caused the need to make the purchase in October.

Mr. Morrow reported that debt service is projected to increase \$500,000, or 8%. The Electric Utility Department has three divisions: construction and maintenance; business, planning, and resources; and engineering and operations. The current staffing level is 45 full-time employees with 19 mandated vacancies. In addition, Electric Utility employs seven contract employees, three of which Mr. Morrow would like to transition into permanent positions: one energy specialist, one utility equipment operator, and one drafting technician. The funds to accomplish this are incorporated in the budget. The remaining contract employees (i.e. two meter readers and two estimators) are on a part-time basis, and Mr. Morrow recommended that those positions continue in that capacity.

In response to Council Member Hansen, Mr. Morrow stated that the two manager positions for the business, planning, and resources division and the engineering and operations division are not currently filled and funds have been budgeted for next year. Mr. Morrow reminded Council that Electric Utility absorbed seven additional positions for collections and meter reading that previously reported to the Finance Department.

City Manager King stated that, as part of tracking the history of the position control in Electric Utility, it was discovered that no regular position had been filled through Human Resources since 1996. It was speculated that those positions were filled as contract employees by unilateral action of the Electric Utility Director in order to bypass established City policies and procedures. Staff is now in the process of inventorying the positions to see which have gone through the approval process, in order to give everyone an equal opportunity to participate in the application and selection process.

Mr. Morrow reported that currently the City is rated BBB+ with a negative outlook that came out of last year's energy crisis. The core issue is that the City will not meet its liquidity target of \$3 million. Staff recently met with Fitch, one of the City's bond rating agencies, to convey this information, and it is unknown at this time what the outcome will be.

Mr. Krueger reported that the City is at the conclusion of a systematic reduction of resources in the Electric Utility Department. Staff anticipates having \$1.7 million in reserves at the end of this fiscal year. In 1996, the City's reserve level was \$23 million. Mr. Krueger outlined the various swaps that took place from 1999 through 2003.

Council Member Hansen stated that, had the electric rates been increased during that time, the City could have avoided the swap and the long-term ramifications that it is now facing. The management approach at the time was to borrow and move funds around, rather than dealing with the issue of increasing rates to pay for the cost of service.

Mr. Krueger agreed and stated that the City bought its way out of a ten-year Calpine contract for \$42 million, which was not reflected as a cost; it was shown as an asset that was amortized over several years. That alone reflected the need for a rate increase. The disadvantage of delaying the rate increase was that the City did not realize the full impact of the revenues. The City should have entered into one-year contracts to get the best price on energy, which is the City's current strategy.

City Manager King stated that the price for energy in the Calpine agreement was \$65 per megawatt hour; it was not a good deal and the contract was bought out. There was an additional debt load that the City took on to avoid the cost and no revenue was brought in to cover the additional piece. The cost should have been accounted for in the rates, and the buy out should have been hedged on the lower side.

Mr. Krueger reported that in 1996 the City had \$20 million in assets, a small amount of liabilities, and a good ratio between total assets and net assets, which then increased to \$40 million over the next few years. If Electric Utility had been sold at that time, the "book value" of those assets would have been \$40 million. In 1999, there was a debt issuance and the City's assets grew; however, the net book value declined. Another debt issuance was done in 2002-03 to buy out the Calpine contract, for which there was no value to that asset. That reduced the assets to a negative net book value, which meant that, if the City had sold the assets, it would have received less proceeds than the assets were worth. To reduce the negative net book value, a rate increase should have been implemented. Electric Utility was in its best financial condition in 1997-98. During the last ten years, there has been a change in practice to reflect the depreciation of resources that took place previously and to bring the value of those assets back up to a financially sound basis.

The in-lieu of and cost of services transfers were highest in 2002-03; however, since then, the percentage has decreased to reflect the actual cost in providing the service. In the past, it was a straight percentage of sales revenues.

In response to Mayor Hitchcock, Mr. Krueger reported that staff reviewed Electric Utility's quarterly report with representatives of Fitch. They are very concerned with the City's thin liquidity margin. The quarterly report was also sent to Standard and Poors; however, no representatives were available to review the information with the City.

In response to Mayor Hitchcock, Council Member Hansen responded that Fitch would like the City to implement a rate increase, possibly within the next six to nine months.

Continued June 6, 2006

C. COMMENTS BY THE PUBLIC ON NON-AGENDA ITEMS

None.

D. ADJOURNMENT

No action was taken by the City Council. The meeting was adjourned at 8:52 a.m.

ATTEST:

Jennifer M. Perrin
Interim City Clerk